PERFORMANCE AND FINANCIAL AUDIT
OF THE

RISK MANAGEMENT DIVISION

DEPARTMENT OF MANAGEMENT AND BUDGET

October 1, 1993 through September 30, 1995

EXECUTIVE DIGEST

RISK MANAGEMENT DIVISION

INTRODUCTION	This report contains the results of our performance* and financial audit* of the Risk Management Division, Department of Management and Budget. The financial portion of our audit covered the period October 1, 1993 through September 30, 1995.
AUDIT PURPOSE	This performance and financial audit was conducted as part of the constitutional responsibility of the Office of the Auditor General. Performance audits are conducted on a priority basis related to the potential for improving effectiveness* and efficiency* . Financial audits are conducted at various intervals to permit the Auditor General to express an opinion on the State's financial statements. Also, this audit complements the departmentwide financial audit.
BACKGROUND	The Risk Management Division (a unit within the Employee Health Management Division beginning in fiscal year 1996-97) was established within the Department of Management and Budget (DMB) in 1987 to improve the State's risk control policies and procedures. The Division is responsible for monitoring and containing costs related to the State's insurance coverage. The Division also provides loss prevention assistance to State departments.

* See glossary on page 30 for definition.

The Risk Management Fund was established as an internal service fund* during fiscal year 1989-90 to account for certain centralized risk management* functions performed by the Division. The Fund is responsible for the centralized purchasing of insurance coverage*, however, the Fund does not assume any risk. Currently, the employee bonding program, automotive liability, Michigan State Fair liability claims, and administrative functions are accounted for as operating activities of this Fund. The Division's financial statements are included in the *State of Michigan Comprehensive Annual Financial Report.*

The Division's activities include analysis of and control over insurance coverage and risk exposure. The State has elected to purchase some level of insurance coverage for aircraft liability, certain State artifacts, builder's risk coverage, boiler and machinery coverage, and employee bonding. In addition, the State has elected not to purchase commercial insurance for some of the risks of loss the State is exposed to and, instead, has self-insured these risks. Each State department receives an annual appropriation which includes funding for the department's costs for the State's insurance programs.

Beginning in July 1992, the State self-insured its automobile liability (referred to as vehicle self-insurance*) exposure. The State was also self-insured for workers' compensation* which was administered by the Accident Fund of Michigan.

As of September 30, 1995, the Division had three employees. For fiscal year 1994-95, the Division incurred total operating expenses of $4.5 million.

* See glossary on page 30 for definition.

AUDIT OBJECTIVES AND CONCLUSIONS

Audit Objective: To assess the effectiveness of the Division's activities to assist departments in containing program costs* .

Conclusion: We concluded that the Division was generally effective in assisting departments in containing program costs.

Audit Objective: To assess the effectiveness and propriety of the Division's services that include funding procedures, including the funding of loss reserves, and claim procedures.

Conclusion: We concluded that the Division's services that include funding procedures, including the funding of loss reserves, and claim procedures were effective and proper.

Audit Objective: To assess the adequacy of the Risk Management Fund's internal control structure*.

Conclusion: Our assessment of the Fund's internal control structure did not disclose any material weaknesses*. However, we identified two reportable conditions* related to allocating program costs and establishing short- and long-term claims payable for the vehicle self-insurance program (Findings 1 and 2).

Audit Objective: To assess the Fund's compliance with applicable statutes, the *Michigan Administrative Code*, State procedures, and department policies and procedures.

∗ See glossary on page 30 for definition.

Conclusion: Our assessment of compliance with laws and regulations did not disclose any instances of noncompliance that could have a material effect on the Fund's financial statements.

Audit Objective: To audit the Fund's financial statements as of and for the fiscal years ended September 30, 1995 and September 30, 1994.

Conclusion: We expressed an unqualified opinion on the Fund's financial statements for the fiscal years ended September 30, 1995 and September 30, 1994.

AUDIT SCOPE AND METHODOLOGY

Our audit scope was to examine the program and other records of the Risk Management Division. Also, our audit scope was to examine the financial records for the period October 1, 1993 through September 30, 1995. Our audit was conducted in accordance with generally accepted auditing standards and *Government Auditing Standards* issued by the Comptroller General of the United States and, accordingly, included such tests of the records and such other auditing procedures as we considered necessary in the circumstances.

Our methodology* included examining program and other records for the period October 1, 1993 through June 30, 1996.

To accomplish our audit objectives, we interviewed Division staff and management. We studied statutory requirements and Division policies and procedures to gain an understanding of the Division's purpose and responsibilities.

* See glossary on page 30 for definition.

We evaluated the reasonableness of the Division's methodology for computing premiums* billed to departments and agencies for the State's vehicle self-insurance program. We assessed the Division's efforts at managing and financing the State's casualty risks for the various risk insurance programs. We also reviewed audit reports of other states' risk management operations to identify the other states' practices for managing and financing casualty risks.

We examined and tested the internal control structure that related to the Risk Management Fund. We identified control strengths and weaknesses to determine the extent of our detailed analysis and testing.

AGENCY RESPONSES

Our audit report includes 2 findings and 2 corresponding recommendations. DMB has agreed with the 2 recommendations.

∗ See glossary on page 30 for definition.

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June 19, 1997

Mr. Mark A. Murray, Director
Department of Management and Budget
Lewis Cass Building
Lansing, Michigan

Dear Mr. Murray:

This is our report on the performance and financial audit of the Risk Management Division, Department of Management and Budget. The financial portion of our audit covered the period October 1, 1993 through September 30, 1995.

This report contains our executive digest; description of agency; audit objectives, scope, and methodology and agency responses; comments, findings, recommendations, and agency preliminary responses; and independent auditor's reports on the internal control structure, on compliance with laws and regulations, and on the financial statements. This report also contains the Risk Management Fund's financial statements and notes to the financial statements and a glossary of acronyms and terms.

Our comments, findings, and recommendations are organized by audit objective. The agency preliminary responses were taken from the agency's responses subsequent to our audit fieldwork. The *Michigan Compiled Laws* and administrative procedures require that the audited agency develop a formal response within 60 days after release of the audit report.

We appreciate the courtesy and cooperation extended to us during this audit.

AUDITOR GENERAL

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DEPARTMENT OF MANAGEMENT AND BUDGET

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Description of Agency

The Risk Management Division (a unit within the Employee Health Management Division beginning in fiscal year 1996-97) was established within the Department of Management and Budget in 1987 to improve the State's risk control policies and procedures. The Risk Management Fund was established as an internal service fund during fiscal year 1989-90 to account for certain centralized risk management functions performed by the Division. The Fund is responsible for the centralized purchasing of insurance coverage; however, the Fund assumes no risk. Currently, the employee bonding program, automotive liability, Michigan State Fair liability claims, and administrative functions are accounted for as operating activities of this Fund. The Division's financial statements are included in the *State of Michigan Comprehensive Annual Financial Report.*

The Division's activities include analysis of and control over insurance coverage and risk exposure. The activities also include planning and implementing a Statewide safety and health policy and program. The State has elected to purchase some level of insurance coverage for aircraft liability, certain State artifacts, builder's risk coverage, boiler and machinery coverage, and employee bonding. In addition, the State has elected not to purchase commercial insurance for some of the risks of loss the State is exposed to and, instead, has self-insured these risks. The State has self-insured most of its general liability and property exposures, but it has not funded these exposures. Each State department receives an annual appropriation which includes funding for the department's costs for the State's insurance programs.

Beginning in July 1992, the State self-insured its automobile liability (referred to as vehicle self-insurance) exposure. The State was also self-insured for workers' compensation which was administered by the Accident Fund of Michigan. The Division billed State agencies through the Risk Management Fund for estimated automobile liability and actual workers' compensation claims paid plus administrative fees. Vehicle claims paid totaled $0.4 million and $1.1 million during fiscal years 1994-95 and 1993-94, respectively. Workers' compensation claims paid totaled $40.7 million and $39.3 million for fiscal years 1994-95 and 1993-94, respectively.

As of September 30, 1995, the Division had three employees. For fiscal year 1994-95, the Division incurred total operating expenses of $4.5 million.

Audit Objectives, Scope, and Methodology
and Agency Responses

Audit Objectives

Our performance and financial audit of the Risk Management Division, Department of Management and Budget (DMB), had the following objectives:

1. To assess the effectiveness of the Risk Management Division's activities to assist departments in containing program costs.

2. To assess the effectiveness and propriety of the Division's services that include funding procedures, including the funding of loss reserves, and claim procedures.

3. To assess the adequacy of the Risk Management Fund's internal control structure.

4. To assess the Fund's compliance with applicable statutes, the *Michigan Administrative Code,* State procedures, and department policies and procedures.

5. To audit the Fund's financial statements as of and for the fiscal years ended September 30, 1995 and September 30, 1994.

Audit Scope

Our audit scope was to examine the program and other records of the Risk Management Division. Also, our audit scope was to examine the financial records for the period October 1, 1993 through September 30, 1995. Our audit was conducted in accordance with generally accepted auditing standards and *Government Auditing Standards* issued by the Comptroller General of the United States and, accordingly, included such tests of the records and such other auditing procedures as we considered necessary in the circumstances.

Audit Methodology

Our methodology included examining program and other records for the period October 1, 1993 through June 30, 1996. Our audit work was performed between November 1995 and January 1997. To accomplish our audit objectives, we interviewed Division staff and management. We studied statutory requirements and Division policies and procedures to gain an understanding of the Division's purpose and responsibilities.

We evaluated the reasonableness of the Division's methodology for computing premiums billed to departments and agencies for the State's vehicle self-insurance program. We assessed the Division's efforts at managing and financing the State's casualty risks for the various risk insurance programs. We evaluated and tested the Division's underwriting techniques; funding procedures, including the funding of loss reserves; and claims procedures. We assessed the Division's efforts to control costs. We also reviewed audit reports of other states' risk management operations to identify the other states' practices for managing and financing casualty risks.

We examined and tested the internal controls structure that related to the Risk Management Fund. We identified control strengths and weaknesses to determine the extent of our detailed analysis and testing.

Agency Responses

Our audit report includes 2 findings and 2 corresponding recommendations. DMB has agreed with the 2 recommendations.

The agency preliminary response which follows each recommendation in our report was taken from the agency's written comments and oral discussion subsequent to our audit fieldwork. Section 18.1462 of the *Michigan Compiled Laws* and DMB Administrative Guide procedure 1280.02 require DMB to develop a formal response to our audit findings and recommendations within 60 days after release of the audit report.

COMMENTS, FINDINGS, RECOMMENDATIONS, AND AGENCY PRELIMINARY RESPONSES

EFFECTIVENESS IN CONTAINING COSTS

COMMENT

Audit Objective: To assess the effectiveness of the Risk Management Division's activities to assist departments in containing program costs.

Conclusion: We concluded that the Division was generally effective in assisting departments in containing program costs.

EFFECTIVENESS AND PROPRIETY OF SERVICES

COMMENT

Audit Objective: To assess the effectiveness and propriety of the Division’s services that include funding procedures, including the funding of loss reserves, and claim procedures.

Conclusion: We concluded that the Division’s services that include funding procedures, including the funding of loss reserves, and claim procedures were effective and proper.

INTERNAL CONTROL STRUCTURE

COMMENT

Audit Objective: To assess the adequacy of the Risk Management Fund’s internal control structure.

Conclusion: Our assessment of the Risk Management Fund’s internal control structure did not disclose any material weaknesses. However, we identified two reportable conditions related to allocating program costs and establishing short- and long-term claims payable for the vehicle self-insurance program.

The Michigan Administrative Information Network (MAIN) is the Statewide financial management system implemented in fiscal year 1994-95. Individual State agencies are not responsible for the design of the Statewide policies and controls of MAIN. However, because MAIN is a Statewide system, which all State agencies are required to use, the internal control structure of each agency, including the Risk Management Fund, is affected to varying degrees by MAIN.

Because the Risk Management Fund's internal control structure is affected by this Statewide system, professional auditing standards required our assessment of the internal controls over the Risk Management Fund to include elements reviewed in our financial related audit of MAIN for the period October 1, 1994 through April 30, 1996. That audit reported 29 reportable conditions, including 3 material weaknesses, which are more fully explained in our separately issued report dated August 31, 1996.

FINDING

1. Self-Insurance Premium Methodology

The Division did not properly compute the State departments' vehicle self-insurance premiums.

The Division self-insures the State's vehicles and charges the departments for their applicable fleet expenses. During our review of the vehicle self-insurance premiums, we noted:

a. The Division did not obtain annual reserve estimates which would have allowed the Division to more accurately estimate the departments' costs and more accurately compute the charges for departments' vehicle self-insurance premiums. The Fund had a deficit fund balance at the end of fiscal year 1994-95 because the Division used the actuary's fiscal year 1992-93 reserve estimate for fiscal years 1994-95 and 1993-94, instead of obtaining more current reserve estimates. The ending fund balances for the vehicle self-insurance program for fiscal years 1994-95 and 1993-94 were approximately ($329,000) and $263,000, respectively. The Division's actuary determined the reserve necessary to fund the vehicle self-insurance program in fiscal year 1992-93 and did not do so again until fiscal year 1995-96.

The Division should ensure that vehicle rates and necessary reserves are reviewed and updated annually to adequately reflect the current costs associated with funding the vehicle self-insurance program. An annual review of the rates and reserves also provides assurance that the methodology for computing the costs of the program is reasonable and will not result in a deficit in the vehicle self-insurance fund balance.

b. The Division overcharged the departments approximately $68,000 during fiscal year 1993-94 because of a computational error. The Division used the prior year's premium which funded both the reserve and the Division's administrative fee for the vehicle self-insurance program. However, the Division mistakenly added the administrative fee into the premium again. This resulted in each of the departments and agencies being charged twice for the Division's administrative fee. The Division became aware of this error, but did not take steps to immediately refund the money to the departments and agencies. Instead, the Division reduced the departments' and agencies' fiscal year 1994-95 premium by the amount of the error.

Properly computing the charges for the departments' vehicle self-insurance premiums is necessary to ensure the accuracy of financial information reported in the Division's financial statements.

RECOMMENDATION

We recommend that the Division properly compute the State departments' vehicle self-insurance premiums.

AGENCY PRELIMINARY RESPONSE

The Department of Management and Budget (DMB) informed us that it has complied with this recommendation by establishing an earlier year-end cut-off date for preparation of final financial analysis that allows for the return to departments of any material overcollections prior to year-end closing.

FINDING

2. Short- and Long-Term Claims Payable

DMB did not have control procedures to help ensure that the Office of Administrative Services (OAS) had properly established accurate short- and long-term claims payable for the vehicle self-insurance reserve at fiscal year-end.

OAS is responsible for establishing claims payable for the vehicle self-insurance program. OAS developed a methodology for computing the short- and long-term claims payable but had not retained documentation supporting the propriety of the methodology. OAS estimated the short-term portion of claims payable based on the previous year's paid claims plus 40%. OAS informed us that the 40% yearly increase was an arbitrary figure and that it did not have any supporting documentation to justify it.

In our review of actual claims paid for the period July 1, 1992 through September 30, 1995, we computed a moving average* increase in claims paid over the previous year to review the reasonableness of OAS's methodology. We used our moving average computations to estimate the short-term payable for fiscal years 1994-95 and 1993-94. We determined that OAS's methodology resulted in short-term claims payable being understated and long-term claims payable being overstated by offsetting amounts for both fiscal years.

The following table presents the amounts recorded as short-term and long-term claims payable, our estimates of the short- and long-term claims payable based on prior years' claims paid, and the overstatement or understatement in the financial statements:

	1994-95	1993-94
Recorded Short-Term Claims Payable	$1,600,000	$ 600,000
OAG Estimate of Short-Term Claims Payable	$2,650,587	$ 954,538
Overstatement (Understatement)	($1,050,587)	($ 354,538)
Recorded Long-Term Claims Payable	$7,140,926	$5,866,626
OAG Estimate of Long-Term Claims Payable	$6,090,339	$5,512,088
Overstatement (Understatement)	$1,050,587	$ 354,538

* See glossary on page 30 for definition.

Although OAS had developed a methodology for computing the short- and long-term portions of the vehicle self-insurance reserve, it was not based on a reliable method of estimating liabilities as required by DMB Administrative Guide procedure 1210.27. As a result, OAS understated its short-term liability and overstated the long-term liability for fiscal years 1993-94 and 1994-95 by offsetting amounts of $354,538 and $1,050,587, respectively. Although these amounts were not material to the Fund's financial statements, internal control procedures should provide for oversight of such accounting transactions.

RECOMMENDATION

We recommend that DMB implement control procedures to help ensure that OAS properly establishes short- and long-term claims payable for the vehicle self-insurance reserve at the fiscal year-end.

AGENCY PRELIMINARY RESPONSE

DMB informed us that it has complied with this recommendation and that a procedure has been written and will be followed during the 1996-97 closing to ensure the proper year-end presentation of short- and long-term claims payable.

COMPLIANCE WITH LAWS AND REGULATIONS

COMMENT

Audit Objective: To assess the Risk Management Fund's compliance with applicable statutes, the *Michigan Administrative Code*, State procedures, and department policies and procedures.

Conclusion: Our assessment of compliance with laws and regulations did not disclose any instances of noncompliance that could have a material effect on the Fund's financial statements.

FINANCIAL ACCOUNTING AND REPORTING

COMMENT

Audit Objective: To audit the Fund's financial statements as of and for the fiscal years ended September 30, 1995 and September 30, 1994.

Conclusion: We expressed an unqualified opinion on the financial statements for the fiscal years ended September 30, 1995 and September 30, 1994.

Independent Auditor's Report on the
Internal Control Structure

January 15, 1997

Mr. Mark A. Murray
Department of Management and Budget
Lewis Cass Building
Lansing, Michigan

Dear Mr. Murray:

We have audited the financial statements of the Risk Management Fund, Department of Management and Budget, as of and for the fiscal years ended September 30, 1995 and September 30, 1994 and have issued our report thereon dated January 15, 1997.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

The management of the Risk Management Division and the management of the Department of Management and Budget are responsible for establishing and maintaining an internal control structure, which operates in conjunction with the Statewide internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our audit of the financial statements for the fiscal years ended September 30, 1995 and September 30, 1994, we obtained an understanding of the Risk Management Fund's internal control structure and internal control elements reviewed as part of our financial related audit of the Michigan Administrative Information Network. The Michigan Administrative Information Network is the Statewide financial management system implemented in fiscal year 1994-95 and, as such, affects the Risk Management Fund's internal control structure. With respect to the internal control structure, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control structure. Accordingly, we do not express such an opinion.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accounts. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the Risk Management Fund's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. The Division's internal control structure did not ensure the proper allocation of vehicle self-insurance costs to the State agencies. Also, the Department did not establish accurate short- and long-term claims payable for the vehicle self-insurance program at fiscal year-end. The reportable conditions are more fully described in Findings 1 and 2.

Also, our financial related audit of the Michigan Administrative Information Network for the period October 1, 1994 through April 30, 1996 noted 29 reportable conditions on the internal control structure which are more fully explained in our separately issued report on the Michigan Administrative Information Network dated August 31, 1996. Although the Risk Management Fund, Department of Management and Budget, is not responsible for the design of the Statewide policies and controls of the Michigan Administrative Information Network, which all State agencies are required to use, these reportable conditions affected the Fund's internal control structure.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the Risk Management Fund's reportable conditions described above is a material weakness. Three of the 29 reportable conditions identified in our financial related audit of the Michigan Administrative Information Network were material weaknesses. These conditions were considered in determining the nature, timing, and extent of the procedures performed in our audit of the financial statements for the fiscal years ended September 30, 1995 and September 30, 1994.

AUDITOR GENERAL

Independent Auditor's Report on
Compliance With Laws and Regulations

January 15, 1997

Mr. Mark A. Murray
Department of Management and Budget
Lewis Cass Building
Lansing, Michigan

Dear Mr. Murray:

We have audited the financial statements of the Risk Management Fund, Department of Management and Budget, as of and for the fiscal years ended September 30, 1995 and September 30, 1994 and have issued our report thereon dated January 15, 1997.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws, regulations, and contracts applicable to the Risk Management Fund is the responsibility of the Risk Management Division and the Department of Management and Budget management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of the Risk Management Fund's compliance with certain provisions of laws, regulations, and contracts. However, the objective of our audit of the financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

AUDITOR GENERAL

Independent Auditor's Report on
the Financial Statements

January 15, 1997

Mr. Mark A. Murray
Department of Management and Budget
Lewis Cass Building
Lansing, Michigan

Dear Mr. Murray:

We have audited the accompanying balance sheet of the Risk Management Fund, Department of Management and Budget, as of September 30, 1995 and September 30, 1994 and the related statement of revenues, expenses, and changes in retained earnings and statement of cash flows for the fiscal years then ended. These financial statements are the responsibility of the Risk Management Fund's management and the Department of Management and Budget management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note 1b, the accompanying financial statements present only the Risk Management Fund and are not intended to present fairly the financial position and results of operations of the State of Michigan or its internal service funds.

In our opinion, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of the Risk Management Fund as of September 30, 1995 and September 30, 1994 and the results of its operations and cash flows for the fiscal years then ended on the basis of accounting described in Note 1b.

AUDITOR GENERAL

RISK MANAGEMENT FUND
Department of Management and Budget
Balance Sheet
As of September 30

ASSETS		1995		1994
Current assets:				
Equity in State Treasurer's Common Cash (Note 1c.)	$	9,452,212	$	7,628,341
Other current assets		175		
Total Current Assets	$	9,452,387	$	7,628,341
Total Assets	$	9,452,387	$	7,628,341

LIABILITIES AND FUND EQUITY				
Current liabilities:				
Warrants outstanding	$	$1,584	$	52,191
Accounts payable and other liabilities		2,191,118		744,274
Amounts due to other funds		9,646		
Deferred revenue		513,400		593,063
Total Current Liabilities	$	2,715,748	$	1,389,528
Long-term liabilities:				
Other long-term liabilities	$	7,153,823	$	5,879,362
Total Liabilities	$	9,869,571	$	7,268,890
Fund equity:				
Retained earnings - unreserved (Note 1d.)	$	(417,184)	$	359,451
Total Fund Equity	$	(417,184)	$	359,451
Total Liabilities and Fund Equity	$	9,452,387	$	7,628,341

The accompanying notes are an integral part of the financial statements.

RISK MANAGEMENT FUND

Department of Management and Budget

Statement of Revenues, Expenses, and Changes in Retained Earnings

Fiscal Years Ended September 30

	1995	1994
OPERATING REVENUES	$ 3.721,302	$ 4.133,145
OPERATING EXPENSES		
Salaries, wages, and other administrative	$ 607,884	$ 592,021
Premiums and claims	$ 3,888.552	3,387,111
Total Operating Expenses	$ 4,496,436	$ 3,979,132
Operating Income (Loss)	$ -775,135	$ 154,013
NONOPERATING REVENUES (EXPENSES)		
Other nonoperating revenues	$	$ 209
Total Nonoperating Revenues (Expenses)	$ 0	$ 209
Income (Loss) Before Operating Transfers	$ -775,135	$ 154,222
OPERATING TRANSFERS		
Operating transfers to other funds	$ -1,501	$ -16,904
Total Operating Transfers Out	$ -1,501	$ -16,904
Net Income (Loss)	$ -775,635	$ 137,318
Retained Earnings - Beginning of fiscal year - restated	359,451	222,133
Retained Earnings - End of fiscal year (Note 1d.)	$ -417,184	$ 359,451

The accompanying notes are an integral part of the financial statements

<u>RISK MANAGEMENT FUND</u>
Department of Management and Budget
Statement of Cash Flows
<u>Fiscal Years Ended September 30</u>

	1995	1994
CASH FLOWS FROM OPERATING ACTIVITIES		
Operating income (loss)	$ (775,135)	$ 154,013
Adjustments to reconcile operating income with net cash provided (used) by operating activities		
Changes in assets and liabilities		
Other assets	(175)	3,822
Accounts payable and other liabilities	2,721,305	2,977,961
Amounts due to other funds	9,646	
Deferred revenue	(79,663)	(469,876)
Net cash provided (used) by operating activities	1,875,978	2,665,921
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
Operating transfers from other funds	$	$ 209
Operating transfers to other funds	$ (1,500)	(16,904)
Net cash provided (used) by noncapital financing activities	$ (1,500)	$ (16,695)
CASH FLOWS FROM INVESTING ACTIVITIES		
Net cash provided (used) - all activities	$ 1,874,478	$ 2,649,226
Cash and cash equivalents at beginning of year	$ 7,576,150	$ 4,926,924
Cash and cash equivalents at end of year	$ 9,450,628	$ 7,576,150
RECONCILIATION OF CASH AND CASH EQUIVALENTS		
Per balance sheet classifications:		
Equity in common cash	$ 9,452,212	$ 7,628,341
Warrants outstanding	$ (1,584)	$ (52,191)
Cash and cash equivalents at end of year	9,450,627	7,576,150

The accompanying notes are an integral part of the financial statements.

Notes to Financial Statements

Note 1 Significant Accounting Policies

a. Reporting Entity

The accompanying financial statements report the financial position and results of operations of the Risk Management Fund, Department of Management and Budget, as of and for the fiscal years ended September 30, 1995 and September 30, 1994. The Fund is a part of the State of Michigan's reporting entity and is reported as an internal service fund in the *State of Michigan Comprehensive Annual Financial Report (SOMCAFR).*

The footnotes accompanying these financial statements relate directly to the Risk Management Fund. The *SOMCAFR* provides more extensive general disclosures regarding the State's Summary of Significant Accounting Policies, Budgeting and Budgetary Control, Treasurer's Common Cash, Pension Benefits and other Postemployment Benefits, and Compensated Absences.

b. Basis of Accounting and Presentation

The financial statements contained in this report are prepared on the accrual basis of accounting. The accrual basis of accounting, which emphasizes the measurement of current financial resource flows, is explained in more detail in the *SOMCAFR.*

The accompanying financial statements include only the Risk Management Fund. Accordingly, these financial statements are not intended to present fairly the financial position and results of operations of the State of Michigan or its internal service funds.

c. Fund Cash Account

A single cash account is maintained by the Fund for use by all the risk management insurance programs. Premiums collected are deposited into the cash account and are invested as part of the State Treasurer's Common Cash fund. Claim payments and administrative expenses are paid from the cash account. Because a single account is used, an individual insurance program can have a deficit cash balance while the fund in total has a positive cash balance.

d. Retained Earnings

The statements disclosed a total fund balance of $(417,184) and $359,451 for fiscal years 1994-95 and 1993-94, respectively. This deficit developed because the Division continued to charge departments for costs based on rates developed from the fiscal year 1992-93 actuarial estimates instead of obtaining more updated actuarial information.

Note 2 Description of Fund

The Risk Management Fund, an internal service fund, was administratively established to account for certain centralized risk management functions performed by the Risk Management Division, Department of Management and Budget, for other State departments and agencies.

The Fund follows accounting standards established by the Governmental Accounting Standards Board. This results in a reporting which is very similar to that used in the private insurance industry. The various component programs within the Fund may incur deficits during a given year, but each program's surplus, unearned premium balance, or deficit is considered in calculating future charges or benefit levels.

This Fund was established during fiscal year 1989-90 to account for insurance management activities being implemented by the Risk Management Division, Department of Management and Budget. Thus far, the employee bonding program, automotive liability, Michigan State fair liability claims, and administrative functions are accounted for as operating activities of this Fund. Expenses and liabilities for claims, including incurred but not reported or not processed claims, have been recorded in the amounts of $8.7 million and $6.5 million for fiscal years 1994-95 and 1993-94, respectively. This includes a long-term portion which is recorded at $7.2 million and $5.9 million, respectively.

Note 3 Risk Management Functions

The State has elected not to purchase commercial insurance for many of the risks of losses to which it is exposed. The State is self-insured for most general liability and property losses, portions of its employee bonding programs, automobile liability, and workers' compensation. These activities are recorded as operating activities of the Fund. In fiscal year 1991-92, a self-insured retention of $100,000 was established for the Michigan State Fair Revolving Fund.

Areas of risk where some level of insurance coverage is purchased include: aircraft liability, property and loss of rents insurance that may be required by bond or lease agreements, certain State artifacts, builder's risk coverage, boiler and machinery coverage, and employee bonding. These transactions are recorded as collections and distributions in balance sheet accounts. Settled claims have not exceeded commercial coverage in any of the past two years.

Changes in the Fund's claims liability for automobile liability for the fiscal years ended September 30, 1995 and 1994 are as follows (in millions):

	1995	1994
Balance - beginning	$6.5	$3.0
Current year claims and changes in estimates	3.4	3.9
Claim payments	(1.1)	(.4)
Balance - ending	$8.7	$6.5

Glossary of Acronyms and Terms

DMB	Department of Management and Budget.
effectiveness	Program success in achieving mission and goals.
efficiency	Achieving the most outputs and outcomes practical for the amount of resources applied or minimizing the amount of resources required to attain a certain level of outputs or outcomes.
financial audit	An audit that is designed to provide reasonable assurance about whether the financial statements/schedules of an audited entity are fairly presented in conformity with generally accepted accounting principles.
insurance coverage	A contract for a specific time period to protect an entity against financial losses arising from accident, injury, theft, etc., which involves transferring risk from an entity to a group for a set premium.
internal control structure	The management control environment, management information system, accounting system, and control policies and procedures established by management to provide reasonable assurance that goals are met and resources are safeguarded; that resources are used in compliance with laws and regulations; that valid and reliable performance related information is obtained and reported; and that financial transactions are properly accounted for and reported.
Internal service fund	A fund established to account for services provided to other funds, with the expenses related to providing services to other State departments and agencies financed by user charges. An internal service fund, which accounts for certain

areas of risk management, follows accounting standards for insurance related industries in accordance with Statement 10 of the Governmental Accounting Standards Board.

MAIN Michigan Administrative Information Network.

material weakness A serious reportable condition in which the design or operation of one or more of the internal control structure elements (including management controls) does not reduce to a relatively low level the risk that errors or irregularities, of a magnitude that would be material in relation to the financial statements or program goals, would not be prevented or detected.

Methodology The general principles and practices used to gain knowledge and evaluate data.

moving average The average of a set of observations which includes each new observation as it becomes available.

OAS Office of Administrative Services, Department of Management and Budget.

Performance audit An economy and efficiency audit or a program audit that is designed to provide an independent assessment of the performance of a governmental entity, program, activity, or function to improve public accountability and to facilitate decision making by parties responsible for overseeing or initiating corrective action.

Premium The consideration paid for an insurance contract.

program costs Costs related to claim expenses.

Reportable condition

A matter coming to the auditor’s attention that, in his/her judgment, should be communicated because it represents either an opportunity for improvement or a significant deficiency in the design or operation of the internal control structure or in management's ability to operate a program in an effective and efficient manner.

risk management

The process of managing an entity's activities to minimize the adverse effects of certain types of losses. The main elements of risk management are risk control (minimization of losses) and risk financing (financing to restore the economic damages of losses).

self-insurance

An entity’s retention of risk of loss, rather than transferring that risk to an independent third party through the purchase of an insurance policy. It is sometimes accompanied by the setting aside of assets to fund any related losses. The entity’s staff or a third party administrator may handle all claims and legal and administrative responsibilities.

SOMCAFR

State of Michigan Comprehensive Annual Financial Report.

workers' compensation

A statutorily required insurance to cover job related accidental injury, disease, or death to covered employees. The insurance provides compensation and medical and legal expenses.